

Sewer Service and Use Charge Fund

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T*o account for the financing, construction, and operation of the sanitary sewer system and for San José's share of the financing, construction, and operation of the regional San José/Santa Clara Water Pollution Control Plant (WPCP). Services provided through this fund are:*

- *Sewer maintenance;*
- *Sewer rehabilitation; and*
- *Sewage treatment at the Water Pollution Control Plant*

Sewer Service and Use Charge Fund

Budget Summary

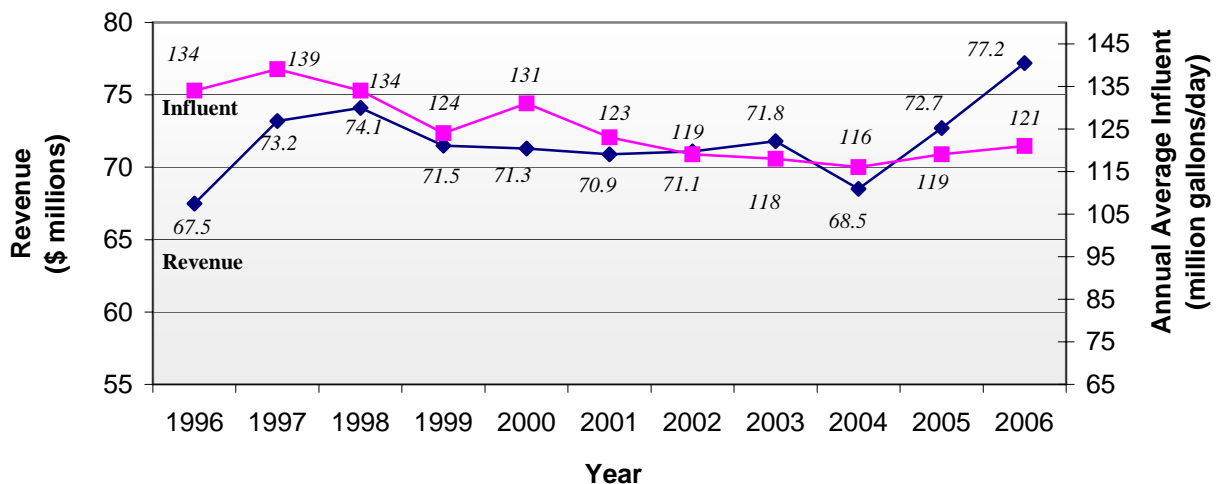
| | 2006-2007 Adopted | 2007-2008 Adopted | Change |
|-------------------------------------|----------------------|----------------------|--------|
| Sewer System Maintenance and Admin. | \$ 20,865,722 | \$ 22,013,952 | 5.5% |
| Sanitary Sewer Rehabilitation | \$ 15,375,000 | \$ 14,475,000 | (5.9%) |
| Water Pollution Control Plant | \$ 49,636,000 | \$ 74,697,000 | 50.5% |

Budget Highlights 2007-2008

- ❑ A rate increase of 9% to the Sewer Service and Use Charge fees was approved in order to adequately fund maintenance and rehabilitation of the sanitary sewer system, Water Pollution Control Plant, and the South Bay Water Recycling program.
- ❑ A total of 22 additional positions was approved to address asset management (5.0), industrial safety (1.0), preventative maintenance (5.0), Plant expansion and reliability (3.0), as-built drawings (5.0), HVAC system (1.0), and additional lab staffing (2.0).

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Sewer Service and Use Charge Fund Historical Trend of Revenues in Relation to Influent Flows (millions of gallons per day compared to revenue in millions)



Sewer Service and Use Charge Fund

Fund Overview

This fund serves as the primary revenue source for several other funds which include the San José/Santa Clara Treatment Plant Operating and Capital Funds, and the Sewer Service and Use Charge Capital Improvement Fund, through annual transfers. In cooperation with the Departments of Environmental Services, Public Works, and Transportation, these funds are managed to deliver services in the most efficient and cost-effective manner.

Included in the fund balance is a Rate Stabilization Reserve of \$2 million, which was established in response to covenants in the bonds issued in 1995 to finance the construction of the South Bay Water Recycling project. The annual debt service cost for that project is \$5.5 million after the refinancing of the bond in 2005-2006. Included in this Adopted Budget is an additional \$6 million in reserves for anticipated future capital financing.

The primary source of this fund's revenues are the fees paid through tax-based assessments within the residential, commercial, and industrial sectors. Prior to 2004-2005, these fees had remained at the same rate for ten years. Also, for the past several years, the Sewer Service and Use Charge (SSUC) Fund had experienced flat or declining revenues in relation to two primary factors. First, the downturn in the economy slowed revenue growth as residential development decreased, rendering the growth rate to below 0.5%. Second, and more significantly, industrial and commercial migration from the area had substantially reduced revenues from these sectors.

Specifically, 3.5% of the decreased revenues is the result of six large industrial users that ceased operations in San José between 2000

and 2004, representing a loss of \$2.5 million in annual revenues. The combined impact of the economic downturn and commercial and industrial migration over the past several years has reduced revenues by a level equivalent to 9% from the high point in 1998-1999.

During the 2004-2005 budget process, the City Council approved a three-year rate increase of 4.5% annually. These increases have reversed the decline in revenue. In terms of the largest revenue source, single-family residence owners, fees have increased from \$18.96 to approximately \$21.64 per month.

Even with these increases, however, the sewer enterprise funds have not been able to avoid deficit spending and reduced capital investment. The continuing inflationary pressures from costs such as employee benefits, energy, and construction have increasingly forced the deferral of capital projects. This includes capital needs throughout the sewer system such as the rehabilitation of pump stations, replacement of sewer lines, and repair of electrical distribution systems within the wastewater treatment facility.

The current projection for 2006-2007 indicates a nearly \$4 million deficit. This is both an indicator of the draw down of reserves throughout the sewer funds, and the lack of available funds for an adequate capital program in all sectors of the sewer enterprise. In a longer term perspective, it is imperative that the deficit spending pattern be resolved through appropriate rate increases.

Although the majority of the operating expenditures associated with this fund have followed a stable and predictable rate of inflation, there have been several items that

Sewer Service and Use Charge Fund

Fund Overview (Cont'd.)

have exceeded expenditure projections during this period. Most notable among these has been the increase in energy costs over the past five years. Natural gas and electricity costs at the treatment plant have risen 35% despite numerous energy efficiency programs that have reduced the energy demand per million gallons treated. Total energy costs for the treatment plant now represent about one-third of all non-personal/equipment costs.

Natural gas prices have continued to increase more than 7% per year on average, and remain volatile and significantly above 1999-2000 levels. Other items that have exceeded the general rate of inflation include vehicle and facility maintenance costs, workers' compensation costs, retirement, and other personnel related costs.

As operating expenses are increasing, the Treatment Plant's capital infrastructure needs are becoming ever more critical. Over 50% of the Plant's infrastructure exceeds thirty years of age, reflecting the expansion to an advanced wastewater treatment facility in the early to mid 1970's. Several major components of the Treatment Plant are reaching the end of their useful years of service, thereby creating the need for critical infrastructure upgrades and rehabilitation projects which are described in the 2008-2012 Adopted Sanitary Sewer System Capital Improvement Program.

In addition to various impending rehabilitation projects over the next ten years, it will be necessary to fund a number of planned security projects at the Plant. The most critical project with the greatest budgetary impact is the conversion from gaseous chlorine as the primary disinfection source to alternate methods in order to address security concerns. The completion of the project, estimated for 2008-2009, is projected to increase chemical costs by \$3.5 million, or approximately 4.5% of current year revenues.

Without adequate revenue inflows, these combined factors will threaten the long-term financial strength of the SSUC Fund and limit the City's ability to aggressively address the capital rehabilitation needs for both the sanitary collection system and the Plant. Future deferral of capital rehabilitation projects or daily maintenance efforts will only diminish the abilities of the Public Works, Transportation, and Environmental Services Departments to achieve and maintain reasonable asset integrity.

Thus, in order to maintain the Fund's long-term financial health, and fund both operations and maintenance requirements and critical capital projects, a rate increase of 9% for 2007-2008 was approved. Moreover, with respect to current revenue and expenditure trends and capital infrastructure needs, it is clear that additional rate increases in the years beyond will be necessary.

Sewer Service and Use Charge Fund

Fund Summary

| | 2005-2006 Actual 1 | 2006-2007 Adopted 2 | 2007-2008 Adopted 3 | % Change (2 to 3) |
|-------------------------------------|--------------------------|---------------------------|---------------------------|-------------------------|
| Dollars by Sources | | | | |
| Beginning Fund Balance | \$ 18,088,348 | \$ 29,735,178 | \$ 27,472,614 | (7.6%) |
| Sewer Service and Use Charges | 76,430,084 | 78,923,155 | 85,677,438 | 8.6% |
| Interest and Other | 712,213 | 499,177 | 1,239,814 | 148.4% |
| Transfers | 12,568,784 | 1,416,000 | 15,300,000 | 980.5% |
| Total | \$ 107,799,429 | \$ 110,573,510 | \$ 129,689,866 | 17.3% |
| Dollars by Uses | | | | |
| Sewer System Maintenance and Admin. | \$ 15,278,756 | \$ 20,865,772 | \$ 22,013,952 | 5.5% |
| Sanitary Sewer Rehabilitation | 14,475,000 | 15,375,000 | 14,475,000 | (5.9%) |
| Water Pollution Control Plant | 46,482,236 | 49,636,000 | 74,697,000 | 50.5% |
| Ending Fund Balance | 31,563,437 | 24,696,738 | 18,503,914 | (25.1%) |
| Total | \$ 107,799,429 | \$ 110,573,510 | \$ 129,689,866 | 17.3% |

Sewer Service and Use Charge Fund

Budget Category: Sewer System Maintenance and Administrative Services

Budget Category Overview

This category is responsible for Sewer System Maintenance and Administrative Services. System Maintenance is performed by the Transportation, Public Works, and General Services Departments to repair damaged sewer pipes and maintain

the system infrastructure. Information Technology Department service costs are also included in this category. Administrative Services include support services provided by various City departments, overhead to the General Fund, fees charged by the County for collecting assessments, and audit costs.

Budget Category Summary

| Sewer System Maintenance and Administrative Services | 2005-2006 Actual 1 | 2006-2007 Adopted 2 | 2007-2008 Adopted 3 | % Change (2 to 3) |
|---|-----------------------------------|------------------------------------|------------------------------------|----------------------------------|
| Sewer System Maintenance | \$ 10,670,708 | \$ 12,784,494 | \$ 14,602,983 | 14.2% |
| Administrative Services | 4,608,048 | 8,081,278 | 7,410,969 | (8.3%) |
| Total | \$ 15,278,756 | \$ 20,865,772 | \$ 22,013,952 | 5.5% |

The following changes were approved in 2007-2008 in the Sewer System Maintenance and Administrative Services allocations:

| Adopted Allocation | 2006-2007 Adopted | Change | 2007-2008 Adopted |
|---------------------------------|------------------------------|---------------------|------------------------------|
| Sewer System Maintenance | \$ 12,784,494 | \$ 1,818,489 | \$ 14,602,983 |

Increases to the Sewer System Maintenance Program for the 2007-2008 Adopted Operating Budget reflect salary and benefit cost increases in the Transportation, Public Works, General Services, and Information Technology Departments (\$524,452), and non-personal/equipment adjustments in the Department of Transportation (\$1,176,500), Public Works Department (\$112,000), and Information Technology Department (\$5,537).

Sewer Service and Use Charge Fund

Budget Category: Sewer System Maintenance and Administrative Services

Budget Category Summary (Cont'd.)

| Adopted Allocation | 2006-2007 Adopted | Change | 2007-2008 Adopted |
|---|------------------------------|---------------------|------------------------------|
| Administrative Services | \$ 8,081,278 | \$ (670,309) | \$ 7,410,969 |
| <p>Changes in the Administrative Services Program for the 2007-2008 Adopted Operating Budget are due in part to the increase and/or shift between funds for Environmental Services Department personal services (\$309,754), GASB 43/45 costs (\$37,743), Planning, Building and Code Enforcement Department personal services (\$27,563), collection costs (\$21,238), City Attorney's Office personal services (\$15,652), and City Manager's Office personal services (\$1,548). These costs are offset by decreases in overhead (\$459,151), Finance personal services (\$275,832), City Hall costs (\$129,559), Integrated Billing System Commercial Paper Repayment (\$117,681), Environmental Services non-personal/equipment (\$100,584), and Finance non-personal/equipment (\$1,000).</p> | | | |
| Total Sewer System Maintenance and Administrative Services | \$ 20,865,772 | \$ 1,148,180 | \$22,013,952 |

Sewer Service and Use Charge Fund

Budget Category: Sanitary Sewer Rehabilitation

Budget Category Overview

The Sanitary Sewer System Rehabilitation category consists of capital projects designed to rehabilitate the sanitary sewer system, with higher priorities given to those with extensive, severe

deterioration. Rehabilitation projects of existing sewers are selected on the basis of pipe corrosion studies, maintenance reports, infiltration analysis, and actual pipe failures.

Budget Category Summary

| | 2005-2006 Actual 1 | 2006-2007 Adopted 2 | 2007-2008 Adopted 3 | % Change (2 to 3) |
|--------------------------------------|--------------------------|---------------------------|---------------------------|-------------------------|
| Sanitary Sewer Rehabilitation | | | | |
| Transfer to Capital Fund | \$ 14,475,000 | \$ 15,375,000 | \$ 14,475,000 | (5.9%) |
| Total | \$ 14,475,000 | \$ 15,375,000 | \$ 14,475,000 | (5.9%) |

The following change was approved in 2007-2008 in the Transfer to Capital Fund allocation.

| Adopted Allocation | 2006-2007 Adopted | Change | 2007-2008 Adopted |
|---------------------------------|----------------------|---------------------|----------------------|
| Transfer to Capital Fund | \$ 15,375,000 | \$ (900,000) | \$ 14,475,000 |

The Sanitary Sewer System Rehabilitation program was for a number of years funded by an annual transfer of \$16 million to the Sewer Service and Use Charge Capital Improvement Fund from the Sewer Service and Use Charge Fund to support the costs of rehabilitation of existing sewers. A decrease of \$1.525 million was approved as part of the 2004-2005 Adopted Operating Budget in response to ongoing deficit spending in the Sewer Service and Use Charge Fund described earlier and was approved to continue at that level in 2007-2008. This transfer supports major projects including those related to the rehabilitation of the Major Interceptor System, neighborhood sewers, and the Inflow and Infiltration (I&I) Reduction projects. The rehabilitation projects will prevent and/or correct pipe failures such as collapses, flow stoppage, and the spilling of sewage. For 2007-2008, the reduction of \$900,000 was due to the elimination of one-time funding in 2006-2007 for the Interceptor Cleaning (\$600,000) and Hydrogen Peroxide Injection Station (\$300,000) projects.

| | | | |
|--|----------------------|---------------------|---------------------|
| Total Sanitary Sewer Rehabilitation | \$ 15,375,000 | \$ (900,000) | \$14,475,000 |
|--|----------------------|---------------------|---------------------|

Sewer Service and Use Charge Fund

Budget Category: Water Pollution Control Plant

Budget Category Overview

This category provides for operational costs, support services, and debt service requirements for the San José/Santa Clara Water Pollution Control Plant (WPCP). This regional wastewater treatment facility serves eight tributary sewage collection agencies, including municipalities and sanitary

sewer districts. The WPCP processes wastewater, operates a Bio-solids Reuse Program, and administers the South Bay Water Recycling Project. In addition, it plans, designs, and constructs new wastewater treatment facilities and provides system maintenance.

Budget Category Summary

| | 2005-2006 Actual 1 | 2006-2007 Adopted 2 | 2007-2008 Adopted 3 | % Change (2 to 3) |
|--------------------------------------|--------------------------|---------------------------|---------------------------|-------------------------|
| Water Pollution Control Plant | | | | |
| Treatment Plant Operating Fund | \$ 36,500,000 | \$ 39,500,000 | \$ 50,000,000 | 26.6% |
| Treatment Plant Capital Fund | 3,072,000 | 4,672,000 | 24,697,000 | 428.6% |
| SBWR Revenue Bonds ('95) | 6,910,236 | 5,464,000 | 0 | (100.0%) |
| Total | \$ 46,482,236 | \$ 49,636,000 | \$ 74,697,000 | 50.5% |

Transfers to the above wastewater-related funds support the operating, capital, and debt service costs of the Water Pollution Control Plant.

The Plant is one of the largest and most complex advanced wastewater treatment facilities in the nation. During the past 50 years, nearly \$1 billion in today's dollars have been invested to transform the Plant from a basic primary level treatment facility to a state-of-the-art advanced treatment plant.

As the majority of the Plant's infrastructure reaches and exceeds 30 years of service, critical aspects such as electrical distribution systems, concrete structures, pumps, motors, piping, and valves need to be replaced or rehabilitated. With less federal funding available, many similar facilities are finding that this reinvestment in infrastructure can only be accomplished with local funding.

One of the primary sources of expenditures in the past several years has been diversion activities associated with the 120 million gallons per day (mgd) flow trigger to the South San Francisco Bay. The diversion of fresh water effluent from the Bay prevents saltwater marsh conversion. This diversion of fresh water has been primarily achieved through the Revised South Bay Action Plan (Plan), as approved by City Council in June 1997.

The projects within this Plan include expanded water recycling, industrial water recycling/reuse, inflow/infiltration reduction, and environmental enhancement pilots. Recycled water is used by industrial and institutional users, diverting water that would otherwise be discharged to the Bay.

Sewer Service and Use Charge Fund

Budget Category: Water Pollution Control Plant

Budget Category Summary (Cont'd.)

The following changes were approved in 2007-2008 in the support of this fund to the Treatment Plant Operating Fund, Treatment Plant Capital Fund, and SBWR Revenue Bonds ('95) allocations:

| Adopted Allocation | 2006-2007 Adopted | Change | 2007-2008 Adopted |
|---------------------------------------|------------------------------|----------------------|------------------------------|
| Treatment Plant Operating Fund | \$ 39,500,000 | \$ 10,500,000 | \$ 50,000,000 |

For 2007-2008, an increase of \$10.5 million to the transfer from the Sewer Service and Use Charge Fund to the Treatment Plant Operating Fund was approved to provide sufficient funds for program expenses related to the Water Pollution Control Plant. Changes to the Adopted Budget reflect salary and benefit cost increases (\$1.9 million), the approved addition of 22 positions described elsewhere in this document (\$2.5 million), and increased energy and chemical costs (\$1.3 million). Transfer amounts from this fund to the Treatment Plant Operating Fund vary each year based on the anticipated ending fund balance.

| | | | |
|-------------------------------------|------------------|-------------------|-------------------|
| Treatment Plant Capital Fund | 4,672,000 | 20,025,000 | 24,697,000 |
|-------------------------------------|------------------|-------------------|-------------------|

In an effort to better demonstrate and quantify the Plant's total capital needs and asset condition, a third-party analysis was accomplished during 2006-2007. This analysis was intended to be a high-level look at the overall condition of the Plant and as well as a high-level review of historic capital replacement and repair funding, and any associated funding gap. Among the findings was that the Plant has a 5-year CIP backlog of \$250 million worth of critical projects. This increased transfer is an attempt to begin to address these needs and reducing the Plant risk of a catastrophic failure. In addition, the reallocation of the SBWR Revenue Bonds ('95) to now be paid out of the Treatment Plant Capital Fund (\$5.5 million) is reflected in this Adopted Budget.

| | | | |
|---------------------------------|------------------|--------------------|----------|
| SBWR Revenue Bonds ('95) | 5,464,000 | (5,464,000) | 0 |
|---------------------------------|------------------|--------------------|----------|

The decrease to this allocation (\$5,464,000) reflects the reallocation of this debt service to be paid out of the Treatment Plant Capital Fund as described above.

| | | | |
|--|----------------------|----------------------|----------------------|
| Total Water Pollution Control Plant | \$ 49,636,000 | \$ 25,061,000 | \$ 74,697,000 |
|--|----------------------|----------------------|----------------------|